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Warburg, Paul Moritz

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[S.l.]

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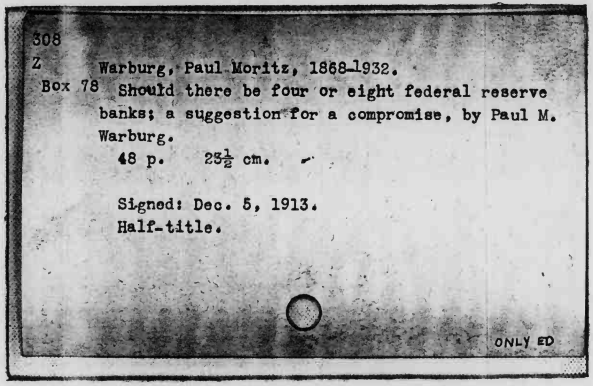
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Should there be Four or Eight Federal Reserve Banks?

A SUGGESTION FOR A COMPROMISE

BY

PAUL M. WARBURG

20 April 1920 Cmd

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The amendments to the Owen-Glass Bill submitted by the two Senate Committees, show most satisfactory progress in many respects, and we may congratulate ourselves that complete agreements have been reached upon many fundamental questions.

On two main points, however, the two Committees still earnestly disagree ; these are the number of the Federal Reserve Banks, and the control of their management.

It is fortunate that in this part of the controversy each side is right and each side is wrong. For this situation carries in itself the possibility of a wise compromise.

Senator Hitchcock and his friends are to be congratulated on the sound stand they have taken in the question of the reduction of the Federal Reserve Banks to a maximum number of four. There is absolute unanimity among all students of the question that the establishment of a discount system, bringing about fluidity of credit and reserves, can best be secured by one central bank. The writer has gone to particular pains to gather the expressions of views of the most prominent men in Europe, among whom there are the presidents of a number of European Central Banks, leading financiers and heads of the largest financial institutions of Europe. They all agree that one central bank would be the best means of developing a discount system. While a majority insists that this is the only way, a few concede that there is a possibility of developing a discount system with several central banks. But all agree that in that case there must be as few as possible and that they must be tied together in an effective way by a business management free from political influence. They also state that if Europe is to be counted upon as an investor in our future American discounts, it will be a prerequisite that there will be a free market for such discounts at home. It is clear that unless the European investor can count on his ability of

reselling such discounts in case he should desire to do so, he would have to consider the purchase of American discounts as an undesirable lock-up of money. If Europe should hesitate to take our American paper freely, our discount system will lose 75% of its beneficial power. That a discount market would develop with a system of eight Federal Reserve Banks, is out of the question. I do not wish to tire the reader by repeating the arguments which I have already advanced in a previous article,* but I venture to append quotations from some of the letters of these European authorities. I am giving only abstracts from these letters, omitting the strong arguments they contain for a central bank and against a note issue by the Government, these two points having passed beyond the phase of further deliberation in the present controversy. These men, some of whom are at the head of institutions of the same character as those that we are about to create here, state in unmistakable terms the grave dangers that would arise from a political influence in the management of such banks, and it is on this question that Senator Hitchcock and his friends go astray, while the views expressed in this respect by Senator Owen and his colleagues cannot be too emphatically endorsed. We need not enlarge upon the consequences that would follow a Government management of the branches. It might debase and corrupt our entire political life, if the fate of the management of the Federal Reserve Banks and their branches would become the plaything of politics. No matter how we safeguard the Government management in the beginning, a nation that flirts with the recall of judges may at any time break down safeguards that we may now impose and all the offices, from that of director down to that of hall porter, might become the spoils of the conquering party. One need

* North American Review, October, 1913.

not emphasize what consequences this might entail for our political and business life.

In dealing with the question of whether there should be four or eight Federal Reserve Banks, we have to concede that in certain respects both sides are right.

From the point of view of securing a strong system and of safeguarding a possibility of developing effective discount markets, there should be only four. From the point of view, represented by the Owen wing, that an intimate touch ought to be established between the management of each Federal Reserve Bank and the District which it represents, and that each District should be certain of receiving the fullest consideration it is entitled to, a system of eight Federal Reserve Banks would appear desirable. Furthermore, it is true that, if we pipe-lined all branches up to four points, a great many of these branches would be located far away from the points of concentration, that the machinery would, therefore, not respond quickly enough and that the sympathetic touch might be lost. The object to be achieved then is to secure the concentration into four units, strong and independent enough to stand on their own feet and to develop fluidity of reserves and a discount market of their own, without at the same time losing by such concentration the necessary touch with the constituent communities.

The writer has repeatedly expressed his belief that in preparing this law insufficient attention has been given to the question of the branches. It is at the branch office that the actual business will be done. Any favoritism or any unfair discrimination will express itself at the branches, where bills are handed in for discount. Sound judgment and business knowledge must be shown here, where alone the character of the bill can be scrutinized and understood. It is therefore most important that the Board of these branches be wisely constituted, and the law, to the mind of the writer, errs, when in this most important point it simply leaves discretionary

power with the Federal Reserve Board and the Federal Reserve Banks. In the writer's opinion the law should not begin by prescribing the election of the Federal Reserve *Bank's* Board, but it should begin by providing for the election of a board for each *branch*. Let the Organization Committee or the Secretary of the Treasury designate those 70 or 80 cities where branches are to be established, and provide that the member banks allotted to each branch elect their boards on lines similar to those provided by the Owen-Glass Bill for the election of the Board of the Federal Reserve Banks. The writer would then suggest that Class "A" be elected by the member banks and that the representatives of these member banks on the board be permitted to be directors or even officers of member Banks. They should have a slight majority in the board, while Classes "B" and "C" would be appointed by the Government. Directors of Classes "B" and "C" would be elected from classes other than bankers; Classes "A" and "B" would constitute the Discount Committee, Class "C" would become the Committee on Supervision. The Chairman of this Committee on Supervision would act as Chairman of the Board. We should in this way constitute a local board which would be representative of all classes, which would command the local knowledge necessary to deal with the local paper, and in which the Government would secure a vote and absolute supervision.

The plan that I have in mind, would then provide for the establishment of eight Regional Federal Reserve Banks, each, let us assume, with about eight branches. But each Regional Reserve City, for its own local business, would have to be treated exactly like a branch, and therefore we would have, including the Regional Reserve City, up to nine organizations, or, let us say, nine branches in each Region, being a total of about seventy-two points at which offices would be created. It is not necessary to start with the full number of these branches in each case, nor need it be limited to eight. However, I am inclined to think that there will not be much less

than 72 when the whole organization will have been mapped out and there will be many more as the country develops.[1]

Let us now assume that the law would be amplified, so that a number of these branch banks, (let us say up to nine), would, in forming one Regional Reserve Bank, elect a Board which would consist of one member to be delegated from each Branch Bank.[2] We would then have eight Regional Reserve Banks, let us say at New Orleans, St. Louis, Chicago, Cincinnati, New York, Boston, San Francisco, and at some other far Western point, *e. g.*, Denver.

I would now propose that in each case, two Regional Reserve Organizations be linked together into one District, so that New Orleans and St. Louis would form one District Federal Reserve Bank, with its head offices in St. Louis. The Chicago and Cincinnati District Federal Reserve Bank would have its seat at Chicago. Boston and New York would together form a District Federal Reserve Bank at New York, and the Denver and San Francisco Federal Reserve Bank would probably have its seat at Denver.[3]

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(1) While the suggestions here made appear to be radical they can be embodied into the law with comparatively few changes not disturbing the general lines of the bill. They follow the structure of the Banque de France and the Reichsbank, where there are local boards at the main branches. As the system develops, agencies or sub-agencies are establsbed as feeders of the branches, or the number of the latter is being increased. The Banque of France has now: one head office, 128 branches with local boards and 71 auxiliary offices and 312 agencies, together 383, which are attached to the branches. The German Reichsbank has now: 1 main bank at Berlin and 20 main branches with separate boards, in additon 76 branches and about 400 side branches.

(2) If there should be less than 5 branches, each branch might delegate two members.

(3) If it would be thought wise to have three Regional Reserve Banks to cover the Pacific Coast, it could be done under this plan without interfering with its general structure. There might be three Regional Reserve Banks, viz.: one at San Francisco, one at Seattle, and one at Denver or Salt Lake City. The three would have one stock capital, and each would delegate one-third of the members to the District Board, which would have its seat at the most centrally situated point,—probably Denver or Salt Lake City. Similarly if at a later time it should be found that Pennsylvania and Maryland should be divorced from New York, the New York District might be divided into three Regions instead of two.

The Boards of these District Federal Reserve Banks would be constituted of four members each, to be designated by each Regional Reserve Bank, and to these would be added the Governor and two Deputy Governors to be appointed by the President of the United States. They would be chosen from lists to be submitted to the President by the eight members of the Board of the District Federal Reserve Bank; the President having the right to reject these lists entirely, asking for new names. If, after three lists would have been submitted, the President and the District Federal Reserve Bank can not agree, the President would choose from one list to be submitted by the Federal Reserve Board. The Governor would be in charge of the District Federal Reserve Bank, the two Deputy Governors each would be placed in charge of the Regional Federal Reserve Banks. The stock to which all the Banks of the various branches subscribe would be that of the District Federal Reserve Bank.

If we review at this point the advantages that would be gained by a plan of this kind, it will become apparent:

FIRST: That the unit of each District is large enough to include varied forms of industrial, agricultural and commercial interests, so that the District will be able in itself to comply more readily with the demands that may spring up from time to time.

SECOND: For transfers and collections, the boundary line within which these will move freely has been enlarged.

THIRD: The local character of the branch boards which will deal with each individual case has been preserved, but the character of the Board of the District Federal Reserve Bank, which will have to deal exclusively with larger problems of policy, from a higher point of view, without consideration of individual wishes, has been delocalized; it has lost its provincial character, all districts being represented.

FOURTH: The four Districts so created will be large enough to command confidence, and large enough to enable the development of discount markets. At the same time, the equality between all branches and between all Regional Banks has been preserved. For its local transactions the central point, *i. e.*, New Orleans, would have a Board, constituted exactly like that of a branch, *e. g.*, Dallas. For its dealings with its branch banks, the Regional of New Orleans would be exactly in the same position as that of St. Louis, and the District Federal Reserve Bank of St. Louis would be constituted from as many members of the New Orleans Organization as that of St. Louis. Full consideration has therefore been given to the apprehension that, by concentration, the sympathetic touch, to be preserved for each Region, might be weakened, and that the central points might gain at the expense of the minor points. An organization of the kind here proposed would remove the reason for any such fear; the parity amongst all eight cities having been strictly safeguarded.

FIFTH: If the plan be carried out that a portion or all of the stock of the Federal Reserve Bank is to be owned by the public, it stands to reason that the latter would much rather buy the stock of a larger organization than that of a smaller one, because the smaller ones are apt to feel to a stronger degree any losses that might be incurred. Moreover, the market for the purchase and sale of these stocks would be a more reliable one, if there were only four different kinds of stock, than if there were eight or ten.

SIXTH: If, at any time, it should be found desirable to sub-divide the Districts into a larger number of Regions, there would not be any difficulty in doing so under this plan, while the difficulty of re-shaping the Districts would be increased if stocks had been sold of too many organizations.

It might be well to explain at this point what would be the functions of each of these three boards. The underlying

principle of an organization as here proposed would be that each branch should be credited with the amount of the capital stock subscribed by its member banks and the aggregate amount of its deposits. On the other hand, each Branch would be debited with the aggregate amount of its investment in commercial paper as well as its proportion of United States Government Bonds taken over and the circulation taken out by the Regional Federal Reserve Banks. Each Branch once a week would give its status to the Regional Bank, which would consolidate all statements of the Branches into one, showing the position of the Regional Bank. Each Regional Bank would then send the consolidated status and that of the individual Branches to the District Federal Reserve Bank, and the latter would consolidate the statements of the Regional Banks into one, and send the same, with such additional information as would be required, to the Federal Reserve Board, which would publish regularly the consolidated and individual statements of the four District Federal Reserve Banks.

The Regional Board would apportion the funds among the branches, permitting, in its discretion, one branch, as a matter of bookkeeping, to draw on the funds of the other, or rather to go deeper into its own reservers, judging by the consolidated status of all its branches the measure up to which each branch may be accommodated. In such deliberation it will be guided, of course, by the fact of whether or not such demands made by any branch are based upon seasonable and sound requirements. The District Reserve Board will, in turn, apportion in a similar way, the funds between the two Regionals, taking into full account the status of each Regional and of its Branches. It need hardly be repeated that fairness of dealing would be assured by having each Regional Board consist of members from each Branch and the District Board constituted by an equal number from both Regions.

The discussion just begun on the Senate floor has already shown the absolute necessity of dealing more explicitly with

this question of Branches. Atlanta desires to be made a Federal Reserve city, because she objects to being forced to rediscount at New Orleans. If this claim should be granted there would be a great many cities, equal or more important in size and banking power, which would justly insist on the same privilege. The consequence would be, that a large number of small and weak Reserve Districts would be created, a system which would be doomed beyond doubt. The plan as proposed by the writer would easily solve this problem in one of two ways: One method would be to subdivide the District into more than two *Regions*, which could be done without weakening the power and basis of operation of the District. The other way would be to have Atlanta satisfied as a Branch. If Atlanta understood that for her local business she would have a local, independent board, just the same as New Orleans, if she understood that the bills rediscounted at Atlanta will normally remain until maturity in the hands of the Atlanta Branch, if Atlanta understood that in the Regional Board she has the same vote as New Orleans, and that for the running of the business of the Regional it is as immaterial whether the Board be located at Houston, Dallas, Atlanta, or New Orleans, as it will be immaterial whether the District Board will be located at St. Louis or New Orleans, she would and should be quite satisfied to become a branch.* The actual business would be done by

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* A Federal Reserve Bank including all the national banks of both Atlanta and Savannah would have a capital (on the basis of 6% of capital and surplus) of about $660,000 and deposits of $600,000 to $1,300,000. The Federal Reserve Bank, on a very liberal calculation, would then have resources of its own of less than $2,000,000. In normal times it might grant accommodations of $700,000, in strenuous times it might grant another $600,000. How long would it last till the Federal Reserve Bank of Atlanta would have given all the accommodation it could provide and till it would have to put its rates so high that any additional requirements would be satisfied from other quarters?

Would not Atlanta fare better and be more secure if she were part of a larger organization? The Atlanta rate would remain more stable and, as a matter of fact, Atlanta would be in a more dignified position.

the Branches and the administrative organizations at the Regional and District points would have the same neutral composition wherever they should happen to be located. As the bill is drawn at present, it is quite unclear how these Branches are to be constituted and what powers they are to have. If they were to be only agencies, run by managers, who would discount bills subject to the approval of the Federal Reserve Bank and who would have to forward these bills to these head points, Atlanta's objection would be fully justified. Moreover, such a slow and cumbersome system would prevent the development of a free discount system, which should make the sale of discounts as quick and as responsive as the calling of a demand Stock Exchange loan. It is to be assumed, however, that the framers of the Owen-Glass Bill have in mind some system of this kind. If they have not, if they intend to give local boards to each Branch, it would be advisable to state this clearly and to let the Member Banks of the District of the Branch have a voice in selecting some of the directors whom they know and trust. This would be better than to have the entire local Branch Board appointed by the Federal Reserve Banks Board, on which there would probably be one single member only representing the district of the Branch. Furthermore, as the Owen-Glass Bill is drawn at present, the anomaly would arise that any Federal Reserve Bank Board would probably not have more than one single member who would be competent to pass on the local discounts of that Federal Reserve city. To illustrate: The Federal Reserve Bank Board of New York would probably be constituted of members from New York, Philadelphia, Pittsburgh, Baltimore, Washington, D. C., Buffalo, Rochester, and possibly Boston, etc. This composite Board, on which there would not be more than one New York member, would have to pass on all the New York paper to be discounted by the New York Federal Reserve Bank. This is, of course, a dangerous and impossible situation. There should be in New

York a local Committee or Board, as there should be in Philadelphia, and the composite Board should deal with questions only of general policy, direction and supervision.

If the Federal Reserve Bank Board or the Federal Reserve Board at Washington, or both together, should have the power to appoint all local boards or to pass exclusively on all purchases of discounts, there would be too much concentration of power in a small group of men,—the very thing that this legislation is planned to avoid.

It is not from a desire to be critical, but from a wish to be helpful, that these defects have been pointed out at such length. The writer is convinced that unless this question of branches be considered with more care a satisfactory system will not be created. There will be either a scattering of reserves or there will be a well-grounded apprehension of too much concentration of power.

Whether there be 4 Federal Reserve Banks with each about 16 Branches, or 4 District Reserve Banks with 2 (or more) Regionals, each, with 8 Branches, is of smaller importance. The writer strongly believes that the latter system is the better, because it will create clearer statistics and, for the Governor in charge, a problem easier to handle.

This question of 8 or 4 Federal Reserve Banks will be easily understood if we translate it into military language. Would we be able effectively to manœuvre 8 armies, if we entirely disconnected them, not permitting them to communicate with each other or to come to each other's assistance, except by way of reporting to headquarters at Washington? Would we not have a better chance of success if above the Generals in charge of each two of these armies we placed one leader, who had authority to detach reserves from one army and throw them to the assistance of the other, or throw both armies into one and divide them again, without costly and dangerous delay and long explanations which might only be half understood at

headquarters? Would not the two armies feel safer and more certain of success? Would they not in fact be stronger than each standing alone? Again, would not the two army corps be better organized by having each an able general and one leader above them, than if the one leader were to manage alone the 16 armies constituting the two army corps?

If the system is to succeed, the units by combination must be large enough to stand alone. If any one of them is so weak that it will frequently have to appeal to others, it will interfere with the others' safety and efficiency. Because, no matter how well the others might keep their own house in order, they could not foretell what their own available resources might be the next day.

Moreover, if these units, though large, are to show a clear picture, which must be fully understood in all its details, if the local and the Washington managements are to be successful, then men and figures must be grouped. The figures must be clarified and simplified and they must crystallize in the brains of the man in charge at each point. The four Governors heading the four District Federal Reserve Banks must rely for their information on the two Deputy Governors who would be in charge of the Regionals, as these in turn would depend on the managers of the Branch Banks. It is not only the larger financial strength that is an absolute prerequisite for an effective system, it is just as important to reduce the problem to so simple and clear a form, assembling men and material, that the Federal Reserve Board can intelligently and successfully deal with it.

It has been claimed that the Federal Reserve Board is not an administrative body, but merely a supervisory board. Nothing could be farther from the truth. If this system is to be crowned with success, the Federal Reserve Board must be an administrative board, and the larger the number of Federal Reserve Banks the more far reaching would become the power and administrative duty of the Federal Reserve Board.

An effective discount policy, an effective gold and foreign exchange policy and an effective method of dealing with the One-Year Treasury Notes and Three Per Cent. Government Bonds can be secured only by a strong and intelligent Federal Reserve Board. On the other hand, intelligence in all these very intricate questions can be displayed by the Federal Reserve Board only if it is in intimate touch with the conditions that exist, not at each point in this country alone, but also in each country of the entire globe. It is impossible for the seven or nine men, sitting in Washington in happy seclusion and far away from the business centres, to deal with these questions wisely, unless intimate touch with those centres be established where all these threads converge. It is true that, in crystallizing the problems of the country up to four points, the difficulties of the Federal Reserve Board will be materially reduced.

Instead of dealing with eight parts and instead of having the duty of equalizing reserves by helping one out of eight,—and simultaneously of singling out one or more out of seven on whom to draw,—the problem would be reduced to judging one case out of four and of distributing the burden amongst the other three. It is even more important that this question of distribution (which with 8 centres might easily become a question of retribution), will come before the Board only at much rarer opportunities, if at all. As to the problem of dealing with bank acceptances, foreign exchange, government bonds and gold, it is much easier to bring about an understanding between four members from large units who have lost their provincial character, than between eight units, where each would have in mind only the advantage of his own little corner.

While the problem has thus been simplified, and while it is conceivable that of the 7 or 9 members of the Federal Reserve Board, 4 might be delegated each to take particular charge of one of the four Districts, the Governor General and the other members of the Federal Reserve Board would

still receive their information by an indirect and ineffective method. It would be infinitely better and immeasurably strengthen the Federal Reserve Board, if the 4 Governors of the four Districts (who would have been appointed by the President), would actually become members of the Federal Reserve Board. These 4 Governors would contribute and impart in a direct way to the other members of the Federal Reserve Board the actual business knowledge necessary to assure a wise management. At the same time a sorely needed opportunity would be given to these four heads of the four District Banks to meet with each other and to discuss with each other conditions as they would exist in each district. This would enable them to form a clear judgment, not only of the conditions governing their District, but also of the other Districts, and thus help them to decide upon a wise policy to be pursued by the Federal Reserve Board, not only for the entire country, but also for each District. In this respect the bill as drawn at present is entirely defective, because it does not provide at all for an exchange of views between the heads of the various Federal Reserve Banks. They run along disconnected from each other, where they should understand and help each other.

The Advisory Board as planned will not fill the gap. The men on that Board cannot possibly have the knowledge, nor speak with the authority of the heads in actual charge, whose main duty it would be to understand and to explain the conditions of their particular District. Moreover, if these four heads, who are responsible for the weal and woe of their District, should have a vote on those questions that so deeply touch their own fate, there would be more confidence in every part of the system that conclusions, no matter whom they might hurt, would have been reached with full knowledge, for the best of the country, and without fear or favor.

I should suggest that the Federal Reserve Board be cut into two parts, the one the Discount Committee, to consist of

these four heads together with the Governor General and two Deputy Governor Generals, to be appointed by the President; the other the Committee of Supervision to consist of the Secretary of the Treasury and such other members as may be designated by the President. The Discount Committee would deal with all questions of routine and of business; the Board of Supervision would be in charge of the supervision of the entire system. Both together would form the Federal Reserve Board, which would pass upon all questions of rules and regulations. The Discount Committee should only be able to act with the consent of the Governor General or the acting Deputy Governor General, and in case of disagreement, the question would have to be brought before the full board, where the Secretary of the Treasury would preside and would have the casting vote in case of a tie. The object of dividing the Board in this way will be apparent without much explanation: It takes the Government official out of the embarrassing position of normally passing upon questions of business, for which the Governor General, appointed by the President, would be mainly responsible; but it gives him supreme power in case of a tie. Furthermore, it gives him supervisory power,—which should be primarily the Government's function,—over the entire system.

The plan as here proposed appears to the writer as a compromise which might be acceptable to both sides to the controversy. It preserves the larger number of the regional reserve banks and brancnes which insure local independence and local sympathetic understanding, but at the same time it combines eight disconnected and weak units into four larger and stronger ones, which will be necessary for the development of any effective discount system.

As far as Governmental influence is concerned, the Government secures supervision from top to bottom. It secures a management appointed by the Government at the top and down to the middle, where the func-

tions of the regional and district Federal Reserve Bank Boards will be those of apportioning funds and of advising and deciding upon the rates at which accommodation should be granted, It leaves the majority at the branches in the hands of business men with a strong share in the management of men appointed by the Government, with a strict supervision not only by the Government, but also by the Regional Banks.

While the highest authorities of Europe, whose system, after all, we are copying, are practically a unit in stating that a perfect discount system can be established only through one single bank, I most confidently believe that—considering all the requirements of our case—we are safe and wise in starting with four units, provided they be properly organized and managed. But nothing will change my profound conviction that a system of eight Federal Reserve Banks, as now proposed, will end in failure. An effective discount rate is the link between the lever and the brake. Without an effective discount rate no European central bank would be able to stand. With eight independent districts (and even with six), no discount market can possibly develop. The safety of the system will be lacking, the member banks' funds will largely remain, as before, in the New York Stock Exchange. It seems scarcely justifiable to legislate the national banks into a position, where they either would have to abandon their National Bank charter and suffer a material loss on their Government Two Per Cent. Bonds, or where, as the only alternative, they would have to throw in their lot with a system that, if carefully administered, could bring only very little relief and which, if managed without such extreme conservatism, would be bound to collapse. If the system be amended on lines as here proposed, objections against such constraint will largely be dispelled, and it might be expected that even a majority of the State Banks and Trust Companies would join.

A management of great ability might, by its sagacity and

impartiality in equalizing reserves, gradually diminish to a certain extent the only too natural apprehension and distrust of the banks. It might, in spite of the law,—by encouraging meetings of the heads of the Federal Reserve Banks amongst each other and with the Federal Reserve Board at Washington,—bring about, to a certain degree at least, the much needed co-operation. But, as planned at present, the heads of the 8 or 10 Federal Reserve Banks would be so busy at home and half of them so far away, that frequent trips to Washington would be impossible. The plan of having *District* Federal Reserve Banks would cure this defect, because the trips would be cut in two and the absence from duty would thereby be reduced to a minimum. The San Francisco manager would once or twice a month go to Denver, where he would meet the head of the Denver and the Seattle Regional Banks. The Governor of the Pacific District, living at Denver, would once or twice a month go to Washington. Moreover, as the Denver Governor's duties do not entail any large amount of detail routine work, he would have and should have the necessary time for extended conferences at Washington. But any wise management, no matter how hard it tried by administrative measures to overcome the defects of the present bill, would be forced to remain close to the shore. The rates would have to be kept high and changes would have to be made frequently in order to keep the District from getting overcrowded or from upsetting the stability of the other Districts. The men in charge, both at Washington and at the Federal Reserve Bank points, would work under a fatal handicap, which it would be cruel and reckless to inflict upon the nation.

It will take a few hours only to amend the bill on lines as here proposed; it will take weeks, and possibly months, of acrimonious debate if a proper basis for a compromise on these two questions cannot be found.

ABSTRACTS

FROM

LETTERS OF EUROPEAN AUTHORITIES.

Extracts from Two Letters of Managers of the Two Largest Banks of Germany.

BERLIN, October 28, 1909.

From Letter No. 1:

* * * As far as this proposed organization is concerned, I need not tell you that I remain a partisan of the One-Bank System. But I am not so theoretical as to refuse to take account of the practical necessities, which differ in the different countries. Life consists of compromises. When the reorganization of our German Banking methods took place in the seventies of the last century, we did not, as you know,—notwithstanding the generally accepted theory of the One-Bank System—carry this system entirely into effect, but allowed a number of private Note-Banks to remain besides the Reichsbank. In practice, however, the Reichsbank was erected upon so broad a basis, and vested with such powerful functions, that, in spite of some theoretical imperfections, it really means the realization of the One-Bank System.

It now appears that in the United States, for purely practical reasons, the creation of a Central Bank is at present no longer being seriously considered. It is likely, therefore, that in this instance likewise a compromise will be effected. As a matter of fact, the Owen-Glass Bill seems to effect a compromise, since it places above the multiplicity of Federal Reserve Banks a Federal Reserve Board vested with far-reaching powers.

The only question is, whether with the compromise selected, the Bill finds a proper solution.

I have my doubts as to this.

If several independent Federal Reserves Banks are to be created, whose relations to one another are to be carried on by means of the Federal Reserve Board,—a body not responsible for the business policy of the individual banks,—then it will be necessary to place each of the Federal Reserve Banks upon

so broad a basis, that according to all human calculation, it will, even in difficult situations, be able to rely upon itself alone, and that it will only in the rarest instances become necessary to fall back upon any other Federal Reserve Bank through the intervention of the Federal Reserve Board.

That the 12 Federal Reserve Banks proposed in the Bill will not under all circumstances be self-sufficient, but may possibly have to rally to one another's support, is acknowledged by the Bill itself, when it does not make the Federal Reserve Board solely a controlling body, but gives this body authority "to permit or require, in time of emergency, Federal Reserve Banks to rediscount the discounted prime paper of other Federal Reserve Banks." (Sec. 12-*b*).

Now, it appears to me to be clear, that such interference will always mean a disturbance of the course of business of such Federal Reserve Bank as will be required by the resolution of the Board to relieve another Federal Reserve Bank of a considerable amount of bills. Even though a Federal Reserve Bank may be managed ever so well, and may be ever so cautious in its dispositions, all its far-sightedness may be completely overthrown by such an interference on the part of the Board. I am entirely of your opinion, that the development of the Federal Reserve Board, and especially of the discount market, which of course still remains to be created in the United States, may and must suffer considerably under the "sword of Damocles" of such authority entrusted to the Federal Reserve Board.

The only way to limit such interference on the part of the Federal Reserve Board as much as possible, and possibly even to make it superfluous, is to give to each Federal Reserve Board a basis which will be broad enough to secure to it an individual independence.

With all due respect to the industrial power and greatness of the United States, I hold it to be impossible that if the entire territory is divided into 12 or even more Federal Reserve Districts, each with a Federal Reserve Bank, every one of these Federal Reserve Banks can be placed upon a basis which will be broad enough to guarantee its independence. Among the twelve Federal Reserve Banks there will necessarily be several, which from the beginning will be too weak to stand on their own feet, and in whose favor the Federal Reserve Board will frequently have to be set in motion; not to speak of the fact that, even in normal times, the dispersal of the cash reserves of the country, that will be brought about through the creation of twelve Federal Reserve Banks, will greatly injure the elasticity of the Currency System, and will prevent a reasonable equalization of the needs of the different sections of the country.

Now, even if it is impossible to obtain a Unit Bank for the entire territory of the United States, with branches in all important cities, I share with you the opinion that, in the interest of the smooth operation of the organization to be created, it is necessary that the number of Federal Reserve Districts, and therewith of the Federal Reserve Banks, be further restricted. I believe that the division of the entire territory of the United States into four or five districts, with four or five independent Banks, will, in the first place, be amply sufficient to care for the industrial conditions of the different sections, and, in the second place, will make it possible to fashion the four or five Federal Reserve Banks into entities having sufficient independence and which will assure a sufficient elasticity of the circulating mediums.

On this basis, it seems to me, it would be possible, also, to waive the objectionable right of intervention on the part of the Federal Reserve Board in regard to rediscounting; for, on the one hand, the cases where a Federal Reserve Bank will have to fall back upon another, will, by their foundation upon a broader basis, become much rarer, if indeed they are not entirely excluded; while, on the other hand, if a case requir-

ing such support should nevertheless occur, the rendering of mutual assistance by way of a ready understanding among the Federal Reserve Banks will be easier where there are only four such institutions to be dealt with, than where twelve have to be taken into consideration. It is clear that, not only in unusual times, but also when matters are running their normal course, the managers of the four Banks must always remain in closest touch with one another. In order to facilitate such intercourse as much as possible, it would be desirable to form a Committee, on which the four Federal Reserve Banks will be represented,—unless it should be preferred to give the management of the four Federal Reserve Banks independent representation directly on the Federal Reserve Board.

Such a modification, as you likewise have in mind, would remain entirely within the limits of the Bill, and in addition would practically remove the above-mentioned objections to the proposed System.

Moreover, in my opinion, the principle, which in the United States, according to popular belief, cannot be gotten away from, *i. e.*, the multiple Bank system, could be given better expression than in the Bill as drawn. A Federal Reserve Board, vested with such far-reaching powers as provided in the Bill, is in reality about the same as a Central Bank. This also appears in other provisions of the law, especially in the regulations regarding the Note issue, to which I will revert further on; but more particularly in the power to require the re-discounting of bills of one Federal Reserve Bank by another, *i. e.*, to shift the liquid assets of the different Federal Reserve Banks back and forth according to necessity or discretion, in a manner such as the Central office of a big institution is entitled to assume towards its branches. * * *

From Letter No. 2:

The less diversified the production of wealth is in a given district, the more likely will the monetary demands upon the respective Central Note institution be made at one and the same period. The larger the territory, however, the greater is the likelihood of diversified means of wealth production within its limits, and in consequence, the monetary requirements of the various undertakings will occur at correspondingly diversified times, resulting in a correspondingly easier adjustment between the supply and demand of money. A Central Note institution may be compared to an irrigation system, which takes up the life-giving element where it exists in abundance, to conduct it to the place where there is a scarcity. If there are not enough reservoirs from which a supply may be had in case of need—that is to say, if the system does not control springs and streams enough to supply it with the life-giving matter, then with every demand that slightly exceeds the normal quantity, the system will break down. For this reason it is, therefore, desirable to include within the operation of a Central Note Institution, as many and as diversified forms of industry as possible.

But it is of a significance equal to that of the breaking down of a Central Note institution, if the latter is very frequently compelled to curtail its discounts, or to increase the rates of discount at short successive intervals, and eventually to a marked degree. Such procedure would lead to a lasting disturbance of the market, and to a loss of confidence or its equivalent, the withdrawal of funds from the Central Note institutions. And the basis for a large, reliable discount market is confidence in its continuously unlimited power of absorption and its ability to satisfy the demands upon it, upon discount terms that are appropriate—that is to say, such as will not be too onerous upon the individual, unless by reason of dire necessity. * * *

The problems confronting an institution like the Central

Note Bank in the Federal Reserve Board are of so manifold a nature, require so intimate a knowledge of the business life both of the Nation involved and of the foreign nations which have to be reckoned with in the international money market, and so close a keeping in touch with the occurrences in the great money centres of the world, demand so thorough a watch upon those tendencies, which in any country in the world may produce a sudden demand for money, or an abundance thereof; presupposes so thorough a study of the currency questions—that it seems to be quite unlikely that individuals who have not devoted lengthy studies to these questions can exercise the management of such an institution, with advantage to the country.

For these reasons, much weight must be attached to the conditions that the Federal Reserve Board—or whatever other body shall exercise the management of the Central Note Bank business in the United States—shall consist only of individuals who have had the benefit of a long experience in questions of commerce, finance and currency. The management of the large Central Note Banks of Europe may be held up as examples in this connection.

The Bank of England whose activities are exercised in a country having a party-government, is entirely independent of the government. The "Board of Directors" consists of 26 directors, elected by the general assembly. Only such persons are eligible for election as directors, as are owners of a considerable amount of the Bank's capital. In consequence, the Board of Directors is composed of the foremost representatives of the commerce of London, and it may be stated in this connection, that while managers of banks are not eligible for election, members of private banking houses ("merchants") are, some of the latter (notably members of the firms of Rothschild, Baring, etc.) having been members of the Board continuously for some time past.

Upon all important questions the decision within the

organization rests with the "Committee of the Treasury", composed of the Governor and Vice-Governor, and former Governors.

The Bank of France, likewise operating in a country having a party government, is managed by the "Council General." This consists of a Governor, 2 Sub-Governors, 15 Regents, 3 Censeurs. While the Governors and Sub-Governors are appointed by the President of the Republic upon recommendation of the Ministers of Finance, and must be large stockholders of the Banque de France, the Regents and Censeurs are elected by the general assembly.

As the Counseil General is required by statute to supervise all the resources of the Bank, and decides upon the rate of interest, length of term of credit, investment of available funds, etc., etc., it may well be said that in the Bank of France, likewise, a management that is private and independent of government influences is guaranteed.

Deviating from the practice of the Bank of England and the Bank of France, the German Reichsbank has an arrangement under which a certain influence upon the business management is conceded to the Government; but again, the fact must not be lost sight of, that in Germany the form of government differs from that prevailing in England and France. * * *

This the following facts will show :

1. With us, the practical business management is entrusted to the Reichsbank-Direktorium, which may be compared to the Federal Reserve Board. It is true that, with us also, the Reichsbank Direktorium consists of members acting in the capacity of officials, and who are appointed by the Bundesrat (Federal Council). But, while the Federal Reserve Board is made up of some high officials of state, whose time and working power are fully taken up with their principal duties, and further of four members appointed for a term of eight years each, the Reichsbank-Direktorium consists only of persons

whose exclusive duty it is to be members of this Board, and who are appointed for life ; by far the greater part of the members of the Reichsbank-Direktorium are graduates from the service of the Reichsbank itself. Our system, therefore, in the first place, assures to the members of the Reichsbank-Direktorium, by reason of their appointment for life, a position independent of political currents, comparable to that of a judge ; and, secondly, the necessary schooling in the technique of banking and business experience.

2. The function of the Central Committee of the German Reichsbank, which may be compared to the Federal Advisory Council, are considerably more extended than those of the Advisory Council. The Advisory Council is to have solely the right to confer with the Federal Reserve Board upon the general business conditions, to make oral or written recommendations regarding subjects which belong to the province of the said Board, and finally, to demand information concerning a number of matters pertaining to the Federal Reserve Board. Its meetings are to take place at least four times per annum. In contrast to this, the Central Committee of the Reichsbank, all of whose members are elected by the shareholders of the Reichsbank, exerts a much greater influence upon the business management. It must meet at least once a month. It may demand information concerning the entire course of business, and has the right to be heard before the respective authorities, in a number of important matters, before a decision is reached thereon ; thus, for instance, as to the filling of vacancies in the Reichsbank-Direktorium, before the Bundesrat reaches a decision; as to the maximum amount to which the Bank's funds may be engaged in collateral loans ; as to the rate of discount and the rate of interest on collateral loans, and as to changes in the manner and terms of granting credits. The purchase of securities for account of the Reichsbank can only be effected

after the amount up to which the Bank's funds are to be engaged for this purpose has been determined, with the previous approval of the Reichsbank-Committee.

But, in addition, the Central Committee elects, from its midst, three deputies and three substitutes, who are charged with the continuous special control of the management of the Reichsbank. These deputies are particularly empowered to attend all meetings of the Reichsbank-Direktorium and take part in its deliberations in an advisory capacity. Such meetings of the Reichsbank-Direktorium take place regularly once a week, and being a substitute deputy of the Central Committee myself, I can testify of my own knowledge that these meetings furnish opportunity for a thorough comparison of views concerning the entire business situation as well as all conditions having an important bearing upon the business management of the Reichsbank.

The deputies further have the right, during ordinary business hours to take cognizance of the progress of business, to inspect the books and security-holdings of the Bank, and to attend examinations of its funds.

In particular, the transactions with the Financial authorities of the Empire and of the German federated States, in cases where other terms than those generally prevalent in banking affairs are to be employed, must previously be brought to the notice of the deputies, and must be submitted to the Central Committee, even if so desired by a single one of them only. They may not be perfected unless the Central Committee gives its approval thereof by a majority vote.

On the strength of these regulations, the Central Committee is in reality an exceedingly important organ in the greater organization of the Reichsbank, while the Federal Advisory Counsel, under the regulations of the Owen-Glass bill could lead only a shadowy existence."

Extracts From Three Letters From Presidents of European Central Banks.

From Letter No. 1:

* * * * * *Therefore a combination which puts the operation into the hands of neutral experts and allots to the government only a proper supervision, deserves the preference. Private interests and public interest are thereby mutually balanced.* For, if on the one hand, private interests are generally cautious and conservative, and more strict in the selection and supervision of the clientele, *i. e.* of the bills offered for discount, on the other hand, *the governmental organs entrusted with the control will see to it that the Bank will never swerve from the laws sanctioned—never enter into transactions which are not permitted to it.*

These principles have been observed in the organization of our National Bank and they have in the meanwhile fully justified themselves. * * *

As to question 3: *I should give unqualified preference to Notes of a Central Bank with government guaranty, over Government Notes. The government may carefully watch over the limit of the Note issue, it may even attend to the manufacturing of the Notes. But beyond that, no warning can be strong enough against mixing private and public credit, which so often has proved dangerous when political crises shake the financial situation of a State.* While in 1870 the Notes of the Banque de France quoted, for a short time, a few per mille below par, French Rentes declined 24%. Had the Note issue in France then been in the hands of the State, the Government Notes would undoubtedly have suffered a much larger depreciation, and the sole cause would have been the amalgamation of government credit with that of the Bank. As it was, the private Banque de France with its note credit intact, was able to render the most valuable service to the State without itself experiencing any trouble. * * *

From Letter No. 2:

* * * * "As to your second question, regarding the system which places the Central Banks under the exclusive management of the government, it may be said in general that such a system is dangerous. And in this connection, let me remind you of a declaration of one of our most eminent statesmen, who founded our Bank. He always fought energetically the idea of a National Bank (Bank d'Etat).

> "At every crisis", he said, "amidst all the scarcity of money, such pressure would be brought to bear on the Government to make it place funds at the disposal of private interests, that it would be incessantly exposed to the dangers of bringing down on itself the most violent hostility and of compromising the country."

Finally, to reply to your third and last question, it is evidently preferable that the Banknotes form a direct obligation of the Central Banks, and not of the Government, *because there is a great advantage in establishing a "Watertight compartment" between the credit of the State and that of the Bank.*

As much as possible private credit must be shielded from shocks which Governments may suffer. Two such opposite situations as those in which the French State and the Banque de France found themselves during the Franco-German War in 1870, furnish the most classic and the most striking example for this. * * * *

From Letter No. 3:

* * * * "Therefore, the first thing to be cared for when starting a bank of issue is its absolute independence from every possible influence. It must be independent not only from private interests, but also from the Government. In the long run dependence on the Government can only have disastrous results for the bank of issue, and it was rightly

stated by Monsieur Thiers, after the Franco-German War, that the Banque de France had saved the country, because this bank of issue had remained fully independent of the Government, and so retained the confidence of the people even at the time when war and the commune were raging and the credit of the Government was greatly impaired.

At the same time it must be understood that a central bank which through its banknotes provides a country with a universal circulating medium, which in many countries is even raised to the rank of legal tender, cannot be compared with an ordinary bank. Although the Government must not be allowed to manage the bank, still it is its duty to supervise and control the management and in most countries it is rightly prescribed that some of its Managers must be appointed by the Government so as to assure and maintain its independence from private interests of the banking community.

I firmly believe that it would be a serious mistake if Government officials were placed at the head of the central banks only because of their being Government officials. I, therefore, fully agree with you that it would be absurd if these places were occupied by officials. A Manager of a central bank never must be subject to the whims of succeeding ministers or other high officials. Moreover, the art of banking and specially the art of managing a central bank is so difficult and its difficulties have increased so greatly in recent years, that at the head of a similar establishment a trained banker is urgently needed, even if he is to be appointed by the Government.

In my opinion Mr. Untermyer fails to see the importance of this point. On a complicated railroad engine the driver has to be an expert and not a Government official, say from the War, Navy, or Treasury Department. Experts have to do the work, though the supervision may be placed in the hands of other persons also to be appointed by the Government.

The great force of a bank of issue lies in its power to centralize the credit facilities of the nation. The bank has to become the big reservoir, back to which the superfluous money will flow as soon as the demand decreases and from which in times of stringency money can be drawn. This reservoir will have to be automatically regulated with the effect that as soon as its contents fall to a danger point, a rise in the bank's rate of discount will send a warning through the country to slow down. As a rule the central bank will also play an important part in the settlement of the balances of trade and of payment with foreign countries and in the maintenance of the rates of exchange at the gold parities. This latter task has increased considerably of later years and it is well known what excellent services have been rendered in this respect by the central banks of Germany, Austria-Hungary, France, and Holland." * * * *

Extracts from Two Letters from Managers of the Largest French Deposit Banks.

From Letter No. 1 :

* * * But the principal question which you put and which is the only one on which I could have an opinion, is, whether Europe would become a purchaser to a large extent of long American bills. In my opinion, Europe would become purchaser of paper (normal paper, it must be understood) on two conditions only, viz. :

1. That payment in gold remains unquestionable and that the gold received in payment would continue to be exported from America without obstacle.

2. That there exist *in America* a ready market for discount so that the European purchaser might be sure to get a bill, which would not eventually mean money locked up.

Whether there will be a ready market in America or not, is a question on which one can have an intelligent opinion in America only. * * * *

From Letter No. 2:

* * * * It is not easy for me, thoroughly imbued as I am by Central Bank ideas, which have approved themselves so well in France, to follow your thought of establishing a system of a minimum of four banks. If a central bank is not feasible in view of the extent of the diversity of economic conditions in the United States, anything that will limit the number of these central banks will prove the greatest benefit to the organization.

Without wanting to compare your immense country with our old and comparatively small republic, I could, however, point out to you the elasticity with which the various branches of the Banque de France in the various provinces accommodate themselves to the very different economic conditions which exist from one end of the country to the other. * * *

The unity of the system does not carry with itself the impossibility of adapting itself to various conditions. * * *

Moreover the difference is more in the expression than in substance, because one central bank does not mean that it alone exercises its functions in a community. Our Banque de France has 200 branches, which are directed by one government, but the operations in each city are in charge of committees, which are elected from the prominent members of industry and commerce of that particular region. Could not a similar method be imitated in the United States by increasing sufficiently the co-operation of the local members of Boards? It would produce the double results, viz: centralization of resources and the judicious administration of the same * * *.

As to note issue, I am of the opinion that the Anglo,—French,—German is preferable to the Russian system (in Russia there is a note issue by the Government). In periods of crises there is a greater inclination to distrust a note issue by a State than that issued by a private bank * * *.

I shall not conclude by saying "either one central bank,

or no reform", but by saying "the smallest possible number of central reserve banks."

The further one goes toward unity in this respect, the more one equalizes the economic forces of a nation the more one fortifies all different markets, bringing to those who need it the excess of funds provided by the richest; the more, finally, one divides the risk by the largest possible extent of the operations, and the more one reduces the consequences of mistakes.

Extracts from Four Letters of English Financiers and Firms.

LONDON, October 23, 1913.

From Letter No. 1:

* * * * 1. In my judgment, strong discount markets can be developed only under an effective discount policy. There should be one policy only, as there is one country and one currency. If there must be more reserve banks, the fewer there are, the better. There is little prospect of American markets being established for discounts under a system differing materially from European systems.

2. I cannot conceive that the business policies of the reserve banks can be satisfactorily controlled by an exclusive Government management.

3. Inasmuch as for the currency to be issued both Government and the reserve banks are responsible, it does not seem to me very material by whom the notes are primarily issued. The question of bookkeeping does not appear to present any difficulty. * * * *

Letter No. 2:

With further reference to your letter of the 6th, I have now had an opportunity of studying the enclosures you were

so good as to forward me, and I confess that the perusal of these papers makes me realize how difficult it is to present to you any considerable opinion which may be of practical value. It is obviously easier to criticise the act under consideration than to suggest any effective and judicious alternatives.

You indicate in your letter that your particular wish is to receive some kind of answer to the several questions which you address me, and I shall therefore limit myself to their consideration.

1. I do not consider that strong discount markets and an effective discount policy could develop under a system of twelve Federal Reserve Banks, and I do not think that Europe would become a free taker of American discounts under such a system.

2. I am opposed to the idea of an exclusive Government management of the Federal Reserve Board.

3. I consider that the powers relating to the providing of an elastic currency should be vested in the Central Bank or Banks, rather than in the Government.

In reply to your question in the postscript, I do not consider that even so few as four large Central Banks co-operating with each other would prove an effective system under which discount markets could develop.

Letter No. 3:

1. We think that a minimum of 12 Federal Reserve Banks would be an element of weakness and that the fewer Reserve Banks started the better it would be. *Four should be the maximum.*

2. The less the Government has to do with the management of the Federal Reserve Boards the better we think it would be. We think that of the seven directors the Government should not nominate more than two, the President and another, leaving the Vice-President to be nominated by the

Directors. We also think that it would not be reasonable to expect that a salary of $10,000 would be a sufficient inducement to a first class business man to accept the post.

3. We agree with your view that it should be the primary obligation of Central Banks with a Government guarantee.

Letter No. 4:

ABSTRACT FROM LETTER OF MANAGER OF ONE OF THE LARGEST ENGLISH DISCOUNT COMPANIES.

I have read with great interest the series of articles contained in the "North American Review" of October last, which you kindly sent me. In accordance with your request, I now write to answer the three questions put before me in your letter of the 6th ultimo, and briefly to express my views upon the subject referred to.

Your first question reads as follows:

> "Can strong discount markets and an effectual discount policy develop under a system of 12 Federal Reserve Banks and would Europe become a free taker of American discounts under such a system?"

with the addition in your postscript, viz:

> "One Central Bank, unfortunately, being out of the question for political reasons, do you believe that four large Central Banks cooperating with each other as suggested in my article would prove an effectual system under which Discount Markets could develop?"

I cannot imagine that a strong Discount Market could develop under such a system as that proposed in the Bill. If four large Central Banks were established, having one policy, and one official rate of discount applying to the whole area, I think a Discount Market of a local character could be readily developed, but certain further changes, to which I allude in

my general view later on, would be required to cause Europe to be a free taker of American discounts.

Question No. 2 reads :

> " How do you view an exclusive Government management of the Federal Reserve Board, which is to coordinate these disconnected 12 organs and which must control their policies ? "

I do not view favorably an exclusive management by the Government of the proposed Federal Reserve Board, even with the latitude to be given to the composition of the Boards of the suggested Regional Banks working under its superintendence. I feel that this system would not be satisfactory in working, and would give rise to criticisms and apprehensions based on political grounds, which might be detrimental to the reputation which such an organization should hold in the estimation of its own community, as well as that of other countries.

The Federal Reserve Board and the various Regional Banks would no doubt appoint trained Bankers for their Executive Officers, but even so, it is very necessary and important that the Directors of these Institutions should have considerable knowledge of business methods, of the credit and reputation of Mercantile and Financial Houses, of the conditions of business prevailing both at home and abroad, and be able to discriminate as to the character of the advances required by Merchants and Bankers. It is doubtful if Government officials, however eminent, would be competent to deal with these questions, and it would be better to provide for Government influence and interest in the Federal Reserve Board and the Regional Banks in a less exclusive manner than that proposed. * * *

On the subject of Currency, I should suggest in the first place, a simplification of the present system of circulation. Let there be one universal issue of Notes, graded in value according to the requirements of the community. These

Notes should be payable in gold at the Head Office of the Issuing Authority and its branches. They should be considered as lawful money of the United States, and their redemption in gold unmistakably indicated on the Note itself.

If the European circulation of the acceptances of Bankers and Commercial Houses in the United States is desired, it must be clearly understood that gold can be obtained in payment of the same under any conditions, provided the acceptors are solvent. At present, I would undertake to say, very few persons outside of experienced dealers in exchange between Europe and America quite know as to what description of currency they could claim, or would receive in payment of a bill domiciled in the United States. * * *

The Notes should be covered by a proportion of gold, and a balance of National or other securities held by the Central Bank, but enough gold should be held to ensure the convertibility of the Notes under all circumstances.

The Elastic Currency to be issued in times of emergency should be of the same character as the ordinary Currency. * * *

Gold or Lawful Money, Note Issue, Government Bonds and Similar Questions.

There has been a rather lively discussion in the papers and in Washington upon the question whether Federal Reserve notes should be paid by the Federal Reserve Banks in "gold" only or in "gold or lawful money;" and furthermore, whether Federal Reserve notes should be counted as reserves by member banks.

Let us first see what is lawful money. The answer is: gold-dollars, silver-dollars (not silver certificates), gold-certificates and greenbacks. Any greenback presented at the Treasury in Washington must be paid in gold. Moreover, the United States, having solemnly undertaken to keep all the various United States currencies at par, even silver certificates presented at Washington would, upon request, be exchanged into gold.

The amended Owen-Glass Bill provides that Federal Reserve notes are to be payable in gold at the United States Treasury and that the notes are to be the obligation of The United States. While it is correct that the United States must not be permitted to pay "one obligation by another." while the United States therefore must pay their notes in gold only, there is no reason why the Federal Reserve Banks should not redeem any obligation redeemable at their counters by paying in lawful money. If the Federal Reserve Banks would be forced by law not to count lawful money as reserve and if they were forbidden to redeem Federal Reserve notes in lawful money, it would mean that by legislative enactment they would be obliged to discredit the sacred pledge of the United States. It would damage the credit of the United States and quite naturally lead to a discrimination between the two kinds of notes which the United States have promised to pay in gold, a most illogical and unwarranted proceeding.

A similar argument must be applied in dealing with the Federal Reserve notes as reserves of member banks.

Reserves of National or State-Banks or Trust Companies have been created for the purposes of providing that these institutions should have available in currency at all times a certain proportion of their deposits, so as to enable them to pay off immediately upon demand substantial amounts of their on demand obligations.

All debts are by law payable in lawful money and the Owen-Glass Bill provides specifically that Federal Reserve Notes be accepted in payment of all taxes and public dues except customs. Is it conceivable that a note which is the obligation of the United States payable at the Treasury in gold and which is receivable for all taxes and public dues as above, shall not be considered as legal tender for any other purpose except the payment of taxes? Would Congress enact a law by which a bank or a private firm might refuse to accept in fulfillment of a contractual obligation a note issued by the United States payable in gold? As long as this note is to be the obligation of the United States let us at least be logical and bold about it and give to this currency the full recognition and privileges to which it is entitled.

If a National Bank could not pay out Federal Reserve notes to any other bank or depositor, how could we expect the member banks to give up their gold certificates and take Federal Reserve notes instead? The strength of the future system will depend, however, upon the amount of gold that the Federal Reserve Banks will be able to assemble in their vaults by substituting the new notes for the old United States currency now in circulation.

But if National Banks must be permitted to pay their depositors in Federal Reserve notes, why should they not be considered reserve money?

Moreover, if a balance with the Federal Reserve Bank is to be counted as cash by a National Bank, how is it possible

that a note should not be so counted? A note could be turned into a balance and balances into notes. How is it possible to discriminate between the two? At the close of business each National Bank might send over to the Federal Reserve Bank or branch, its Federal Reserve notes and have them credited to its account, taking them back the next morning for use as till money. In that case the balance over night would count as reserve. If the bank happened to keep the notes over night in its own vaults, it is claimed that they should *not* be counted as reserve. Could anybody imagine any theory more confused and untenable?

In the writer's opinion, there cannot be any doubt whatsoever that the Hitchcock Committee errs when it insists that Federal Reserve notes presented for payment at the Federal Reserve Banks must be paid in gold alone. They ought to be payable in lawful money. Furthermore, it goes astray when it bars Federal Reserve notes as legal reserve for member banks. Member banks are to observe only the commercial point of view of having a safe proportion of their deposits in cash balances or actual cash. Federal Reserve Banks are to safeguard a safe proportion between their on-demand obligations and available lawful money. But it is the United States' function and duty to provide for the fulfillment of its own promise at all times to pay in gold the notes issued by the United States as payable in gold.

The latest amendment by the Democratic caucus, of creating a new circulating note to be the obligation of the Federal Reserve Banks and to be secured by the 2% Government bonds purchased from member banks, can only be considered as a most regrettable error of judgment. If, on the one hand, it has been claimed, that the Federal Reserve notes must be the primary obligation of the United States and that the Federal Reserve Banks should not be permitted to issue the same as their own obligation to be guaranteed by the United States,

if it has been stated, in justification of this point of view, that the people of the United States would not consider themselves safe except with a direct Government note, how can we be expected to consider favorably this latest proposition?

This circulating note of the Federal Reserve Banks is to be secured by Government bonds—is not that a Federal Reserve Bank note secured by a guarantee of the United States?

Only with this difference that the previous recommendations, which were declined, had in mind a note issued by the Federal Reserve Banks guaranteed by the United States, but covered by commercial paper, a certain amount of Goverment bonds *and an ample gold reserve; but all notes were to be an equal first lien on the assets of the Federal Reserve Banks.* The Democratic caucus now provides for a 35% gold cover and a first lien for the notes of the Government, and expects the Federal Reserve Bank notes to be absorbed as second mortgage notes, apparently without an equal gold protection, while the old National Bank Notes—after the National Banks would have placed the bulk of their cash in the hands of the Federal Reserve Banks and for the protection of the Government notes—are to continue as third mortgage notes, until the last remnant of this unfortunate National Bank circulation willl be redeemed *after 30 years* from the passage of this law! That the Secretary of the Treasury is to be clothed with the power of permitting National Banks to count their own notes as reserve is another aberration which suggests the thought of whether a merchant would be kept out of jail, if, by permission of the Secretary of the Treasury, in making up his balance sheet he would count his own promissory notes as quick assets.

The problem of dealing with the Government bonds and the National Bank circulation is a perplexing one and we must, unfortunately, face the fact that for the next few years, at least, we shall have to be satisfied with some system which will not be quite free from theoretical and, to a certain extent, actual

defects. But should we not try to create a system which will shorten as much as possible these years of transition and which, after that period, will become logical, sound and simple?

Is it not clear that we must work towards *one* note issue? Think of the anomalous conditions that would arise if on the one hand the Federal Reserve Organization, by a liberal policy of note issue, should force the national bank notes to quick redemption and out of circulation and if, on the other hand, at times when the Federal Reserve policy would aim at contraction of circulation, the national banks would again begin to put out their circulating notes. The note-issue policy must cooperate with the general discount policy, and both should be thrown into one hand as quickly as possible.

Sufficient consideration does not appear to have been given to the fact that when once the banks have thrown their reserves together with the Federal Reserve Banks—no matter whether the circulating notes are still being issued by the National Banks individually—any obligation to redeem them in gold, in case of contraction or foreign demand, will fall upon the Federal Reserve Banks and incidentally on the United States, which for the redemption of its Federal Reserve Notes must rely on the strength and solvency of the Federal Reserve Banks.

The Federal Reserve Banks, from a point of view of gold cover, will have to consider as their own obligations the National Bank currency, whether or not they assume this from the start.

It would therefore be the wisest and safest plan to assume the National Bank circulation as rapidly as possible, so that, as long as the responsibility rests with the Federal Reserve Banks, they will at least at the same time become the owners of the assets securing this circulation and so that they may receive the benefit of the profits of this circulation, without

which, it is to be feared, they will not have a sufficient earning power.

However, the taking over of all government bonds at once would alienate the country banks, which do not want to forego their note-issuing privilege so rapidly and it would frighten a great many individuals, who are unable to perceive that the difference is only one of form. Moreover the formal status of the Federal Reserve Banks would become greatly weakened with respect to the gold cover to be provided against notes issued to them by the Federal Reserve Board against these purchases of 2% Government bonds. Let us assume as the first year's balance sheet the following statement, in millions:

Assets.		*Liabilities.*	
Discounts	$150	Capital paid in	$50
Cash	450	Deposits from Banks	400
		Treasury	150
	$600		$600

if we added to the assets $350 millions of 3% Government Bonds and $350 millions of One-Year 3% United States Treasury Notes, we would have

Discounts	$150	Capital	$50
Cash	450	Deposits	400
3% Gov. Bonds	350	Treasury	150
3% One-Year Treas. Notes	350	Notes	700
	$1,300		$1,300

which would mean a gold cover for notes of 64%, and of liabilities of 36%, which latter percentage would leave little room for a liberal increase of the note issue with which to supply the commercial requirements of the nation. If, however, we assume that within the next five years it should be

possible to substitute $500,000,000 new Federal Reserve Notes for lawful money in circulation the balance sheet would look as follows:

Discounts	$150	Capital	$ 50
Cash	950	Deposits	400
3% Gov. Bonds	350	Treasury	150
3% One-Year Treas. Notes	350	Notes	1200
	$1800		$1800

This would show a gold cover for Notes of almost 80% and for liabilities of about 50% and would leave a vast margin of safety for the accommodation of the member banks and for the status of the Federal Reserve Banks. The further this substitution of Federal Reserve Banks for lawful money circulation would proceed the stronger the Federal Reserve Banks would become and with that the position of the United States.

It follows then : first, that there must be only one kind of notes, which must be eagerly accepted by the people and the member banks. The Federal Reserve Treasury Note must therefore have all legal tender qualities, except payment for customs, and must be counted as reserve money by the member banks. Otherwise the free substitution of the new notes for old will be interfered with.

SECOND : That as rapidly as this substitution proceeds, the Federal Reserve Banks, with the approval of the Federal Reserve Board and the Secretray of the Treasury, ought to be permitted to increase the purchases and conversion of the 2% Government Bonds.

How quickly this process can be carried on, nobody is in a position to foretell today.

It would therefore be a mistake to attempt now to lay down a hard and fast program for the future. The law should be so framed as to give ample latitude in this respect to the men to be placed in charge who should be able to meet conditions as they will arise.

I should suggest that the law be amended so as to provide that the Federal Reserve Board purchase from the member banks no less than 5% annually of the aggregate face value of the 2% United States Government Bonds outstanding as a basis for National Bank circulation at the time of the passing of the law, but that the National Banks be required to turn over annually up to 10% of said aggregate amount, in case the Federal Reserve Board, with the approval of the Secretary of the Treasury, should decide to purchase up to that quota. I should furthermore provide that additional amounts may be purchased in the open market, in case the Federal Reserve Board, with the approval of the Secretary of the Treasury, should think this advisable. If this method be applied, the National Bank circulation could be eliminated within ten years provided that the status of the Federal Reserve Banks would permit.

As the gradual acquisition of the 2% Bonds would proceed, the Federal Reserve Banks would convert the same half and half into U. S. Government 3% 20 year Bonds, and One-Year United States Treasury Notes, to be renewed annually as provided in the bill. The Federal Reserve Board, with the approval of the Secretary of the Treasury, should have full power to dispose of the Twenty-Year 3% Goverment Bonds. They might find it desirable to retain the bulk of these bonds. If, however, for the permanent strengthing of the status of the Federal Reserve Banks, it should be advisable to dispose of a portion of the bonds, the management can be trusted to do so in the best manner, adapting itself to the conditions as they would exist from time to time. No legislative body can foresee now what these conditions will be. The One-Year Notes would normally be held in the Treasury of the Federal Reserve Banks and form there a most valuable means of combating emergency situations as they might arise. They should be the free property of the

Federal Reserve Banks, and the Federal Reserve Board should have full power to deal with the same.

It should be the object of this law to secure under strict Governmental supervision the best possible Board, and the most efficient management, and to lay down the broad rules upon which the future institution is to be run. But no warning can be too emphatic not to attempt to legislate too strictly concerning questions of administration. I believe it is a fair statement that there is not a single member in both houses of Congress who would feel qualified to undertake the management of this future institution. How then can they be expected to lay down the law in detail the effect of which cannot now be foreseen?

This refers not only to the question of Government Bonds, but it has a very distinct bearing also on the question of discounting. The general principle ought to be that,—as in the majority of the European Central Banks,—normally no paper should be bought having to run more than ninety days. Inasmuch as the law, as drawn at present, contains an emergency clause which would enable the Board to purchase all kinds of obligations of the banks in case of need, it appears quite unnecessary to provide, as proposed in the Hitchcock amendment, that bills having a maturity up to 180 days and not to exceed $200,000 might be bought from each member bank. This clause looks petty and small, and would not warrant the breaking down of an important principle. In a similar way the Hitchcock amendment goes astray when it fixes a minimum amount that any bank at any time may require the Federal Reserve Banks to rediscount for it, and when it determines *now* the increase in rates for any additional rediscounts the member bank might require. The Federal Reserve Banks' management must be trusted to be fair and reasonable; it would be unwise to place it in a position where it could be dictated to or where it would have to be exacting against its better judgment. Instead

of laying down iron-clad laws, it might be better to insert a broader clause which would permit the Federal Reserve Board from time to time to establish rules, permitting or requiring the Federal Reserve Banks to charge a higher rate than the regular bank rate published, when member banks ask for rediscounts in excess of certain limits to be fixed by the Federal Reserve Board. This would give the Federal Reserve Banks and the Federal Reserve Board a means of protecting themselves, in case they found it necessary, but it would not bind their hands unnecessarily as long as a healthy supply of legitimate bills would be offered for rediscount.

In closing, the question of the ownership of stock of the Federal Reserve Banks, might be touched upon, which ought to be dealt with from a similar point of view. It might prove a good basis for a compromise if the member banks, who shall be required to subscribe for the stock, were to be permitted, after three years and with the approval of the Federal Reserve Board and the Secretary of the Treasury, to sell all or a certain portion of their stock holdings, provided, however, that each bank would remain responsible to its Federal Reserve Bank for the liability following the stock certificate. If this plan were adopted the public would not now be asked to subscribe for a stock which during the first few years might conceivably not earn its full dividend. The banks, on the other hand, would not be required indefinitely to tie up their own resources, which part of the scheme appears to be most objectionable to them.

It is not the desire of the writer to go further into a discussion in detail of the various sections of the law, but rather to confine himself to the above remarks, concerning a few of the main points. However, he ventures to hope that his arguments may have convinced the reader that the amendments as proposed by the two Senate Committees cannot, by any means, lay claim to being considered as final and definite conclusions. Further careful deliberation will be necessary if the

law is to become as perfect as the nation may justly expect. Much as speedy legislation must be desired by everybody, the problem appears to demand further open-minded discussion by calm and intelligent brains. Rather than to drive it roughshod to a quick conclusion, as a party measure upon which the final word has already been spoken, it would seem that the shorter and, in the long run, the better way would be for both sides to give and to take and to agree upon the middle course that safety lies between the cliffs.

December 5, 1913.

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